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Nos. 622-630

IN THE

Supreme Court of the United States

OCTOBER TERM, 1949

B. D. PHILLIPS, et al., Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

B. D. Phillips, T. W. Phillips, Jr., Thomas W. Phillips, III, Roger S. Phillips, Idell H. Phillips, Margaret Phillips Succop, Estate of Alma J. S. Phillips, Deceased (Union Trust Co. of Butler, Hazel Frazier, T. W. Phillips, Jr., and A. Craig Succop, Executors), Estate of Undine C. Phillips, Deceased (B. D. Phillips, Administrator), and Ruth Phillips Bisiker, petitioners above named, respectfully pray that writs of certiorari issue to review the judgments of the United States Court of Appeals for the Third Circuit entered in these cases.

OPINIONS BELOW.

The Findings of Fact and Opinions of The Tax Court of the United States (R. 122a-140a, 154a-158a) are reported at 11 TC 653 and 8 TC 1286. The Opinion of the Court of Appeals (R. 174-176) is not yet officially reported.

JURISDICTION.

The judgments of the Court of Appeals were entered on December 2, 1949 (R. 176-184). The jurisdiction of this Court is invoked under Title 28, United States Code, Section 1254 (1).

QUESTION PRESENTED.

Whether a statutory closing agreement covering the taxable years 1938 and 1939, entered into between Pennsylvania Investment and Real Estate Corporation and the Commissioner of Internal Revenue, under Section 3760 of the Internal Revenue Code, and properly executed by the Acting Secretary of the Treasury, based solely on the determination of the Commissioner of Internal Revenue that the corporation had no undistributed earnings or profits in the years 1938 and 1939, plus proof that the corporation had no earnings or profits in 1940 and 1941, established the fact that distributions made by the corporation to petitioners in the year 1941 were not made from accumulated earnings and profits.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved may be found in the Appendix, *infra*, pp. 1a-3a.

STATEMENT.

The facts with respect to the issue herein involved, as found by the Tax Court (R. 124a-130a) and as contained in a stipulation of the parties and oral testimony and exhibits submitted at hearings before the Tax Court, are substantially as follows:

Petitioners are individuals or fiduciaries with residences or places of business in Butler, Pennsylvania (R. 124a). These proceedings were consolidated for hearing in the Tax Court and in the United States Court of Appeals for the Third Circuit, and have been consolidated for the purpose of this review (R. 5a, 171, 172, 173).

On December 19, 1928, Pennsylvania Investment and Real Estate Corporation ("Pennsylvania" herein) was incorporated under the laws of the State of Delaware. All of the capital stock of Pennsylvania, consisting of 60,000 shares, was issued to T. W. Phillips Gas & Oil Company for certain assets of the latter Company. This transaction constituted a nontaxable reorganization under the Revenue Act then in effect, and the 60,000 shares of stock of Pennsylvania were distributed by the T. W. Phillips Gas & Oil Company to its shareholders on a share-for-share basis, the latter Company also having 60,000 shares of its capital stock outstanding at the date of said reorganization (R. 26a, 27a).

During 1941, petitioners, who were shareholders of Pennsylvania, received distributions from Pennsylvania in the following amounts (R. 125a):

B. D. Phillips	$28,319.40
T. W. Phillips, Jr.	18,922.40
Thomas W. Phillips, III	1,917.00

Roger S. Phillips	$1,907.00
Idell H. Phillips	1,800.00
Margaret Phillips Succop	1,899.00
Estate of Alma J. S. Phillips	5,400.00
Estate of Undine C. Phillips	1,800.00
Ruth Phillips Bisiker	1,980.00

During 1941, Pennsylvania distributed $108,000 to its shareholders. The amounts set forth above represent the proportionate shares of the petitioners in the total distribution of $108,000 (R. 125a).

The earnings or profits realized by Pennsylvania from the date of its incorporation in 1928 through the taxable year ended December 31, 1940, were substantially less than the distributions made by the corporation to its shareholders during said period. In the year 1941, Pennsylvania suffered a net loss from operations and realized no earnings or profits (R. 27a, 125a, 126a).

Pennsylvania filed with the Collector of Internal Revenue for the 23rd Collection District its corporate income and excess profits tax returns and personal holding company tax returns for the years 1938 and 1939, reporting net income for excess profits tax purposes of $82,563.61 for the year 1938, and $80,638.75 for the year 1939. The total income and excess profits taxes paid on the income reported in its returns amounted to $5,157.75 for the year 1938, and $3,228.69 for the year 1939. On its tax returns the Company claimed dividends paid credits of $90,598.33 for 1938 and $77,617.16 for 1939 (R. 126a). The dividend paid credit of $90,598.33 for 1938 included dividend paid credit carry-overs from 1936 and 1937 in the respective amounts of $53,362.64 and $1,235.69 (R. 105a).

An Internal Revenue Agent made an investigation of Pennsylvania's tax returns for the years 1938 and 1939. As a result of his investigation and audit, the Revenue Agent disallowed $50,126.64 of the dividend paid credit claimed by Pennsylvania for the year 1938, and $8,617.16 of the dividend paid credit claimed by Pennsylvania for the year 1939 (R. 68a, 126a, 127a). In explanation of the disallowance of Pennsylvania's dividends paid credits for the years 1938 and 1939, the Revenue Agent stated in his report as follows (R. 59a, 60a, 82a):

> "The principal cause of the additional assessment is due to adjustment made to Dividend Paid Credit claimed for the years 1938 and 1939, it being held that distributions made in excess of the accumulated earnings and profits do not constitute taxable dividends and, therefore, are not includible in the dividend paid credit.
>
> * * * * * *
>
> "The dividend paid credit of $90,598.33 claimed, includes a dividend carry-over of $53,362.64 from the year 1936 and $1,235.69 from the year 1937 * * *.
>
> "Since the taxpayer corporation had no accumulated earnings and profits either at the beginning of the year 1936 or 1937, the dividend paid credit for those years is limited to the amount of earnings and profits in those years which was available for distribution to stockholders; any distributions in excess of available earnings being a distribution of capital and, therefore, not includible in the dividend paid credit."

The Revenue Agent, in his Report, after disallowing Pennsylvania's dividends paid credits, as hereinbefore described, determined that Pennsylvania was liable for additional income tax and surtax on personal holding Company income for the years 1938 and 1939 in the following amounts (R. 70a, 71a, 86a, 110a, 111a, 126a, 127a):

1938	Income Tax	$ 1,186.28
	Surtax on personal holding company income	27,089.56
1939	Income tax	233.26
	Surtax on personal holding company income	5,952.98
	TOTAL	$34,462.08

On December 27, 1940, the Commissioner of Internal Revenue submitted a closing agreement (Form 866) which was executed by Pennsylvania on December 30, 1940, pursuant to the provisions of Section 3760 of the Internal Revenue Code (R. 128a). The taxes determined in said closing agreement were in the exact amounts as determined by the Revenue Agent in his Report (R. 69a, 128a), plus the taxes originally paid by Pennsylvania on the income reported on its 1938 and 1939 returns. The closing agreement was signed by the Commissioner of Internal Revenue on March 8, 1941 (R. 128a) and was approved by the Acting Secretary of the Treasury on March 18, 1941 (R. 128a), and on March 21, 1941, the Commissioner of Internal Revenue advised Pennsylvania that said agreement had been approved. A copy of said agreement was transmitted to Pennsylvania (R. 96a).

In 1941, shortly after the approval of the closing agreement by the Acting Secretary of the Treasury,

Pennsylvania paid the additional taxes determined therein in the amount of $34,462.08, plus interest of $3,945.01. No part of the said additional taxes has since been refunded to Pennsylvania. Pennsylvania's shareholders filed no refund claims for 1938 and 1939 (R. 70a, 71a, 130a).

In entering into the closing agreement, the Commissioner of Internal Revenue was cognizant of the fact that there had been a tax-free reorganization in 1928, and that Pennsylvania had acquired its assets from T. W. Phillips Gas & Oil Company in a tax-free exchange. In the Revenue Agent's report, an adjustment was made wherein Pennsylvania's surplus was credited in the amount of $472,578.82, said amount representing the difference between the fair market value of the assets acquired from T. W. Phillips Gas & Oil Company in exchange for capital stock of Pennsylvania and the transferor's basis thereof (R. 72a, 73a). It was stipulated that Pennsylvania did not obtain the closing agreement by fraud or malfeasance or misrepresentation of a material fact (R. 28a, 130a).

At the first hearing before the Tax Court, the parties, by agreement and with the consent of the Court, presented for decision a preliminary question involving the effect on petitioners of the closing agreement under Section 3760 of the Internal Revenue Code covering the tax liability of Pennsylvania for the years 1938 and 1939. The issue thus presented, which was common to all of the petitioners, was whether the closing agreement covering the tax liability of Pennsylvania for the years 1938 and 1939 established the fact that Pennsylvania had no accumulated earnings or profits as of the end of 1939, and whether this fact, coupled with proof that

Pennsylvania accumulated no earnings or profits in 1940 and 1941, established the ultimate fact that the distributions of 1941 were not from accumulated earnings or profits, and hence did not constitute taxable dividends in the hands of the shareholders (R. 122a, 123a, 133a).

After this preliminary question had been decided unfavorably to petitioners in the Opinion of the Tax Court of June 26, 1947 (R. 122a-140a), the case was reopened for the purpose of permitting the parties to introduce proof as to the extent of the undistributed earnings or profits of Pennsylvania in 1941 when the distributions were made (R. 142a). This question later came on for hearing before the Tax Court sitting in Pittsburgh. At this hearing petitioners contended that the closing agreement plus proof that Pennsylvania had no accumulated earnings or profits in 1940 and 1941 made out a *prima facie* showing that Pennsylvania had no accumulated earnings when it made the distributions in 1941. Petitioners then rested their case, contending that the burden of going forward had shifted to respondent (R. 143a-150a). The Tax Court again decided the issue favorably to the Commissioner, holding that the petitioner had not overcome the presumption of correctness of the Commissioner's determination of the deficiencies in taxes in respect of each of the petitioners in so far as they were based on the distributions in question and approved the deficiencies as determined by the Commissioner (R. 154a-158a).

The Court of Appeals affirmed the decisions of the Tax Court and held that the closing agreement did not, by its terms, purport to settle anything more than the amount of the taxpayer's liability, and that inasmuch as the agreement was between a corporate taxpayer and

the Commissioner, these petitioners were strangers to that agreement and were neither bound by it nor permitted to take advantage of it (R. 174a-176a).

SPECIFICATION OF ERRORS TO BE URGED.

The Court of Appeals erred:

1. In holding that the closing agreement entered into between Pennsylvania and the Commissioner on Form 866 did not, by its terms, purport to settle anything more than the amount of Pennsylvania's tax liability for the years 1938 and 1939.

2. In holding that petitioners were strangers to the closing agreement and were neither bound by it nor permitted to take advantage of it.

3. In failing to hold that proof of the closing agreement covering the years 1938 and 1939, and proof of the fact that said agreement was based solely upon the Commissioner's determination that the corporation had no undistributed earnings as of the end of 1939, plus proof that the corporation accumulated no earnings in 1940 and 1941, made out a *prima facie* case that the corporation had no accumulated earnings for distribution in 1941, thus shifting the burden of going forward with the evidence to the Commissioner.

4. In affirming the decisions of the Tax Court.

REASONS FOR GRANTING THE WRIT.

1. These cases present an important new question not previously decided by this Court involving what issues are settled as the result of a statutory closing agreement entered into between a taxpayer and the Commissioner on Form 866.

Section 3760 of the Internal Revenue Code provides that if an agreement is entered into in accordance with the statute, and there is no showing of fraud or malfeasance or misrepresentation of a material fact, then "The case shall not be reopened *as to the matters agreed upon*" (emphasis supplied), and in any suit, action or proceeding, such agreement shall not be "annulled, modified, set aside or disregarded."

The statutory closing agreement, which was entered into between Pennsylvania and the Commissioner, settled more than the mere tax liability of Pennsylvania for the years 1938 and 1939. It necessarily settled the issue upon which the determination of the tax liability was based.

The Internal Revenue Agent, representing the Commissioner of Internal Revenue, determined that Pennsylvania had no accumulated earnings or profits either at the beginning of the year 1936 or of the year 1937. As a result he denied a dividend paid credit carry-over from 1936 and 1937 and limited the dividend paid credit for 1938 and 1939 to the amount of earnings or profits realized by Pennsylvania in 1938 and 1939 and held that the distributions in excess of the available earnings in those years were made from capital and were not includible in the dividend paid credit. He determined that Pennsylvania had no accumulated earnings or

profits at the end of the year 1939. He thus determined deficiencies in income tax and personal holding company surtax for said years aggregating $34,462.08.

The said deficiencies resulted *solely* from the Commissioner's determination that Pennsylvania had no accumulated earnings or profits either at the beginning of the years 1936 and 1937 or at the end of the year 1939. There was no other issue involved. The taxes determined in the closing agreement were exactly the same as the deficiencies determined by the Revenue Agent in his Report plus the amounts originally paid by Pennsylvania for the years 1938 and 1939.

In *Commissioner of Internal Revenue v. Sansome,* 60 F.(2d) 931 (C. C. A. 2d 1932); cert. den. 287 U. S. 667, it was held that, in a corporate reorganization in which no gain or loss is recognized, the earnings or profits of the predecessor corporation remain earnings or profits of the successor corporation. This principle has been well-established law since 1932, at least. The Commissioner must have considered the full import of the *Sansome* decision, when he held that Pennsylvania had no accumulated earnings or profits at the beginning of 1936 or of 1937 or at the end of 1939. The Commissioner knew that in the year 1928, Pennsylvania had acquired assets from T. W. Phillips Gas & Oil Company in a corporate reorganization in which neither gain nor loss was recognized, and that Pennsylvania had acquired the accumulated earnings and profits of the transferor. In the face of the *Sansome* decision, he determined that Pennsylvania had no accumulated earnings and profits either at the beginning of 1936 or 1937 or at the end of 1939.

If Pennsylvania had accumulated earnings or profits at the beginning of 1936 and 1937 or at the end of 1939, as the Commissioner now contends, Pennsylvania was entitled to a dividend paid credit for each of the years 1938 and 1939. But Pennsylvania is forever foreclosed from claiming the disallowed dividend paid credit for such years by reason of the statutory closing agreement. If Pennsylvania is bound by the closing agreement, it follows that the Commissioner is likewise bound.

Numerous decisions make it clear that if a particular item is considered by the parties and an agreement is reached and such agreement is reduced to a statutory closing agreement, the parties are forever barred from disregarding the treatment accorded such item except upon showing of fraud, etc., even though the closing agreement on its face shows only the amount of tax resulting from the determination of the parties with respect to such item.[1]

In construing Section 1106(b) of the Revenue Act of 1926, a counterpart of Section 3760 of the Internal Revenue Code, Judge Augustus N. Hand, in *Aetna Life Ins. Co. v. Eaton, supra,* at p. 714, stated:

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[1] Parish & Bingham Corporation v. United States, 44 F. (2d) 993 (Ct. Cl. 1930); Columbia Steel & Shafting Co. v. United States, 44 F. (2d) 998 (Ct. Cl. 1930); Lloyd-Smith v. United States, 44 F. (2d) 990 (Ct. Cl. 1930); Aetna Life Ins. Co. v. Eaton, 43 F. (2d) 711 (C. C. A. 2d 1930); cert. den. 282 U. S. 887 (1930); Bankers' Reserve Life Co. v. United States, 42 F. (2d) 313 (Ct. Cl. 1930); Perry v. Page, 67 F. (2d) 635 (C. C. A. 1st 1933); Wolverine Petroleum Corp. v. Commissioner of Int. Rev., 75 F. (2d) 593 (C. C. A. 8th 1935); Commissioner of Internal Revenue v. Ingram, 87 F. (2d) 915 (C. C. A. 3rd 1937).

"But the section in terms covers everything except fraud, and can have little use if it permits new questions to be raised after a closing agreement is executed. The agreement was made pursuant to the statute and is bound to be given the effect therein prescribed. Section 1106(b) excludes mistakes of fact, and a fortiori of law, as grounds for recission. Only fraud, malfeasance, or misrepresentation are mentioned as a basis for attacking the assessment, and none of these is alleged to have existed."

The statutory closing agreement established the fact that Pennsylvania had no accumulated earnings or profits at the end of 1939. Petitioners proved, and it is admitted, that Pennsylvania had no accumulated earnings or profits in 1940 and 1941. Petitioners thus established the ultimate fact that the distributions made by Pennsylvania in 1941 were not from accumulated earnings or profits, and hence did not constitute taxable dividends in the hands of the shareholders.

2. The Court of Appeals held that even if the closing agreement, as executed, settled facts in addition to the amount of tax liability of Pennsylvania, the petitioners cannot take advantage of the agreement because they were strangers thereto. This overlooks the underlying basis of this inquiry.

It is true that the question presented in the instant case is whether petitioners received taxable dividends from Pennsylvania in the year 1941. But that question depends on whether or not Pennsylvania had earnings or profits accumulated after February 28, 1913. A shareholder must necessarily depend upon the corpora-

tion for information bearing upon the taxability or non-taxability of corporate distributions. Any evidence bearing upon the amount of earnings or profits accumulated by Pennsylvania after February 28, 1913, is clearly admissible to determine the taxability of the distributions received by the petitioners from Pennsylvania in 1941. The closing agreement conclusively established the fact that Pennsylvania had no accumulated earnings or profits at December 31, 1939 inasmuch as the agreement was founded on the Revenue Agent's determination that there were no such earnings or profits. Hence, the closing agreement must be given the same force and effect as if the petitioners had been parties thereto.

A shareholder is so in privity with, and represented by, the corporation that he is bound by a judgment against the corporation in so far as it deals with corporate rights and liabilities and affects the shareholders as a body.[2] A shareholder is so in privity with the corporation, that a decision holding that the corporation acquired properties in a taxable exchange was *res adjudicata* of the question in a subsequent proceeding between the Commissioner and a shareholder of the corporation.[3] A statutory closing agreement is, by its terms, more conclusive than the doctrine of *res adjudicata.*

3. At the hearings before the Tax Court petitioners established (1) that a closing agreement under Section 3760 of the Internal Revenue Code was entered into between the corporation and the Commissioner of Internal Revenue, covering the years 1938 and 1939, the

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[2] 34 Corpus Juris 1026.

[3] D. Bruce Forrester v. Commissioner of Internal Revenue, 4 TC 907 (1945).

effect of which was to determine finally that the corporation had no undistributed earnings as of the end of 1939; (2) that there was no fraud or malfeasance, or misrepresentation of a material fact in connection with said closing agreement (this being stipulated by the parties); and (3) that the corporation accumulated no earnings in 1940 and 1941 (which was likewise stipulated by the parties). Petitioners took the position that proof of these facts made out a *prima facie* showing and shifted to the Commissioner of Internal Revenue the burden of going forward with the evidence as to whether Pennsylvania had undistributed earnings in 1941. This contention was denied by the Tax Court, which held that petitioners had offered no evidence as to whether the corporation had undistributed earnings when it made the 1941 distributions. The Court of Appeals did not comment on this contention.

A similar point was raised by the Commissioner in *Commissioner of Internal Revenue v. Bain Peanut Co.*, 134 F. (2d) 853 (C. C. A. 5th 1943), cert. granted 320 U.S. 721 (1943), dismissed on motion of counsel for petitioner, 321 U.S. 800 (1944). In this case the Commissioner had offered evidence before the United States Processing Tax Board of Review, purporting to overcome a statutory presumption favorable to the taxpayer, and contended that said proof shifted the burden of going forward to the taxpayer. The Processing Tax Board of Review denied the Commissioner's contention. The Court of Appeals reversed. This Court granted the taxpayer's motion for a writ of certiorari. As heretofore indicated, the case was dismissed on motion of counsel for the taxpayer, presumably because a settlement was reached by the parties in the interim. Thus this Court has once granted certiorari on a point on all

fours with that raised herein but did not decide the case.

4. Taxpayers are continually entering into closing agreements on Form 866 with the Commissioner of Internal Revenue. It is a fair assumption that such a closing agreement is forever binding on both parties, not only as to the amount of the tax but as to all issues upon which the tax is based. The issue presented in the present cases will arise in other cases.

Conclusion.

Petitioners submit that the question is of such importance as to warrant review by this Court and that this petition for writs of certiorari should be granted.

Respectfully submitted,

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SIDNEY B. GAMBILL,
Attorneys for Petitioners.

APPENDIX.

Internal Revenue Code:

SEC. 3760 CLOSING AGREEMENTS.

(a) *Authorization.*—The Commissioner (or any officer or employee of the Bureau of Internal Revenue, including the field service, authorized in writing by the Commissioner) is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period.

(b) *Finality.*—If such agreement is approved by the Secretary, the Under Secretary, or an Assistant Secretary, within such time as may be stated in such agreement, or later agreed to, such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact—

(1) The case shall not be reopened as to the matters agreed upon or the agreement modified, by any officer, employee, or agent of the United States, and

(2) In any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith shall not be annulled, modified, set aside, or disregarded.

* * * * * * *

Treasury Decision 4855, 1938-2 Cumulative Bulletin 252, promulgated under the Internal Revenue Code:

ARTICLE 1. CLOSING AGREEMENTS RELATING TO TAX LIABILITY IN RESPECT OF INTERNAL-REVENUE TAXES. —Closing agreements provided for in section 606 of the Revenue Act of 1928, as amended, may relate to any taxable period ending prior or subsequent to the date of the agreement. With respect to taxable periods ending prior to the date of the agreement, the matter agreed upon may relate to the total tax liability of the taxpayer or it may relate to one or more separate items affecting the tax liability of the taxpayer, as for example, the amount of gross income, deductions for losses, depreciation or depletion, or the year for which an item of income is to be included in gross income or the year for which an item of loss is to be deducted, or the value of property on a specified date. A closing agreement may also be entered into in order to provide a "determination under the income tax laws" as defined in section 820 (a) (1) (A) of the Revenue Act of 1938. With respect to taxable periods ending subsequent to the date of the agreement, the matter agreed upon may relate only to one or more separate items affecting the tax liability of the taxpayer. The following, among others, are examples of the latter type of closing agreement: (1) A taxpayer may sell a portion of his holdings in a particular stock. A closing agreement may be entered into fixing the cost or other legal factor determining the basis for computing gain or loss on such sale, and, at the same time fixing the cost or other legal factor determining the basis (unless or until the statute is changed to require the use of some other

factor to determine basis) of the remaining portion of the stock still held by the taxpayer upon which gain or loss will be computed when the taxpayer sells such stock in a later year; (2) if the taxpayer is undecided whether to sell property or hold it, or as to the price at which to sell it, a closing agreement may be entered into determining the market value of the property as of March 1, 1913, for future taxable periods, prior to the consummation of the sale by the taxpayer. A closing agreement with respect to any taxable period ending subsequent to the date of the agreement is subject to any change in or modification of the law enacted subsequent to the date of the agreement and applicable to such taxable period, and each closing agreement shall so recite. Closing agreements may be executed even though under the agreement the taxpayer is not liable for any tax for the period to which the agreement relates. There may be a series of agreements relating to the tax liability for a single period. Any tax or deficiency in tax determined pursuant to a closing agreement shall be assessed and collected, and any overpayment determined pursuant thereto shall be credited or refunded in accordance with the applicable provisions of law.

The procedure in the Bureau of Internal Revenue with respect to applications for entering into closing agreements in accordance with these regulations will be under such rules as may be prescribed from time to time by the Commissioner.

These regulations apply to any closing agreement entered into on and after May 28, 1938, the date of the enactment of the Revenue Act of 1938. Article 1301 of Regulations 74 is hereby superseded.